Bank Runs and Water Shortages

Murray N. Rothbard

It was a scene familiar to any nostalgia buff: all-night lines waiting for the banks (first in Ohio, then in Maryland) to open; pompous but mendacious assurances by the bankers that all is well and that the people should go home; a stubborn insistence by depositors to get their money out; and the consequent closing of the banks by government, while at the same time the banks were permitted to stay in existence and collect the debts due them by their borrowers.

In other words, instead of government protecting private property and enforcing voluntary contracts, it deliberately violated the property of the depositors by barring them from retrieving their own money from the banks.

All this was, of course, a replay of the early 1930s: the last era of massive runs on the banks. On the surface the weakness was the fact that the failed banks were insured by private or state deposit insurance agencies, whereas the banks that easily withstood the storm were insured by the federal government (FDIC for commercial banks; FSLIC for savings and loan banks).

But why? What is the magic elixir possessed by the federal government that neither private firms nor states can muster? The defenders of the private insurance agencies noted that they were technically in better financial shape than FSLIC or FDIC, since they had greater reserves per deposit dollar insured. How is it that private firms, so far superior to government in all other operations, should be so defective in this one area? Is there something unique about money that requires federal control?

The answer to this puzzle lies in the anguished statements of the savings and loan banks in Ohio and in Maryland, after

the first of their number went under because of spectacularly unsound loans. "What a pity," they in effect complained, "that the failure of this one unsound bank should drag the sound banks down with them!"

But *in what sense* is a bank "sound" when one whisper of doom, one faltering of public confidence, should quickly bring the bank down? In what other industry does a mere rumor or frisson of doubt swiftly bring down a mighty and seemingly solid firm? What is there about banking that public confidence should play such a decisive and overwhelmingly important role?

The answer lies in the nature of our banking system, in the fact that both commercial banks and thrift banks (mutual savings and savings-and-loan) have been systematically engaging in fractional-reserve banking: that is, they have far less cash on hand than there are demand claims to cash outstanding. For commercial banks, the reserve fraction is now about 10%; for the thrifts it is far less.

This means that the depositor who thinks he has $10,000 in a bank is misled; in a proportionate sense, there is only, say, $1,000 or less there. And yet, both the checking depositor and the savings depositor *thinks* that he can withdraw his money at any time on demand. Obviously, such a system, which is considered fraud when practiced by other businesses, rests on a confidence trick: that is, it can only work so long as the bulk of depositors do not catch on to the scam and try to get their money out. The confidence is essential, and also misguided. That is why once the public catches on, and bank runs begin, they are irresistible and cannot be stopped.

We now see why private enterprise works so badly in the deposit insurance business. For private enterprise only works in a business that is legitimate and useful, where needs are being fulfilled. It is impossible to "insure" a firm, even less so an industry, that is inherently insolvent. Fractional reserve banks, being inherently insolvent, are uninsurable.

What, then, is the magic potion of the federal government? Why does everyone trust the FDIC and FSLIC even though their reserve ratios are lower than private agencies, and though they too have only a very small fraction of total insured deposits in cash to stem any bank run? The answer is really quite simple: because everyone realizes, and realizes correctly, that only the federal government—and not the states or private firms—can print legal tender dollars. Everyone knows that, in case of a bank run, the U.S. Treasury would simply order the Fed to print enough cash to bail out any depositors who want it. The Fed has the unlimited power to print dollars, and it is this unlimited power to inflate that stands behind the current fractional-reserve banking system.

Yes, the FDIC and FSLIC "work," but only because the unlimited monopoly power to print money can "work" to bail out any firm or person on earth. For it was precisely bank runs, as severe as they were that, before 1933, kept the banking system under check, and prevented any substantial amount of inflation.

But now bank runs—at least for the overwhelming majority of banks under federal deposits insurance—are over, and we have been paying and will continue to pay the horrendous price of saving the banks: chronic and unlimited inflation.

Putting an end to inflation requires not only the abolition of the Fed but also the abolition of the FDIC and FSLIC. At long last, banks would be treated like any firm in any other industry. In short, if they can't meet their contractual obligations they will be required to go under and liquidate. It would be instructive to see how many banks would survive if the massive governmental props were finally taken away.

Water *Not* Running

Most people agree that government is generally less efficient than private enterprise, but it is little realized that the difference goes far beyond efficiency. For one thing, there is a crucial difference in attitude toward the consumer. Private business firms are constantly courting the consumer, always eager to increase the sales of their products. So insistent is that courtship that business advertising is often criticized by liberal aesthetes and intellectuals as strident and unmannerly. But government, unlike private enterprise, is not in the business of seeking profits or trying to avoid losses. Far from eager to court the consumer, government officials invariably regard consumers as an annoying intrusion and as "wasteful" users of "their" (government's) scarce resources. Governments are invariably at war with their consumers.

This contempt and hostility toward consumers reaches its apogee in socialist states, where government's power is at its maximum. But a similar attitude appears in areas of government activity in all countries. Until a few decades ago, for example, water supplies to consumers in the United States were furnished by private companies. These were almost all socialized, so that government has come to monopolize water services.

In New York City, which shifted to a monopoly of government water several decades ago, there was never, in previous decades, any wailing about a "water shortage." But, recently, in a climate that is not conspicuously dry, a water shortage has reappeared every few years. This July water levels in the reservoirs supplying New York City were down to an unprecedented 55% of capacity, in contrast to the normal 94%. But surely, nature is not solely to blame, since neighboring New Jersey's water levels are still at a respectable 80%. It seems that the New York water bureaucrats must have carefully sought out nearby spots that particularly suffer from chronic drought. It also turns out that the New York pipe-

lines were constructed too narrowly to increase water flow from wetter regions.

More important is New York's typical bureaucratic response to this, as well as to other periodic water crises. Water, as usual with government, is priced in an economically irrational manner. Apartment buildings, for example, pay a fixed water fee per apartment to the government. Since tenants pay nothing for water, they have no incentive to use it economically; and since landlords pay a fixed fee, regardless of use, they too couldn't care less.

Whereas private firms try to price their goods or services to achieve the highest profit—i.e. to supply consumer needs most fully and at least cost—government has no incentive to price for highest profit or to keep down costs. Quite the contrary. Government's incentive is to subsidize favored pressure groups or voting blocs; for government is pressured by its basic situation to price politically rather than economically.

Since government services are almost never priced so as to clear the market, i.e. equate supply and demand, it tends to price far below the market, and therefore bring about an artificial "shortage." Since the shortage is manifest in people not being able to find the product, government's natural despotic bent leads it invariably to treat the shortage by turning to coercive restraints and rationing.

Morally, government can then have its cake and eat it too: have the fun of pushing people around, while wrapping itself in the cloak of solidarity and universal "sacrifice" in the face of the great new emergency. In short, when the supply of water drops, governments almost never respond the way a business firm would: raise the price in order to clear the market. Instead, the price stays low, and restraints are then placed on watering one's lawn, washing one's car, and even taking showers. In this way, everyone is exhorted to sacrifice, except that priorities of sacrifice are worked out and imposed by the government, which happily decides how much lawn water-

ing, or showering, may be permitted on what days in the face of the great crisis.

Several years ago, California water officials were loudly complaining about a water shortage and imposing local rationing, when suddenly an embarrassing event occurred: torrential rains all over the drought areas of the state. After lamely insisting that no one should be misled by the seeming end of the drought, the authorities finally had to end that line of attack, and then the title of the Emergency Office of Water Shortage was hastily changed to the Office of Flood Control.

In New York, this summer, Mayor Edward Koch has already levied strict controls on water use, including a ban on washing cars, and imposition of a minimum of 78 degrees for air conditioners in commercial buildings, plus the turning off of the conditioners for two hours during each working day (virtually all of these air conditioners are water-cooled). 78 degrees is tantamount to no air-conditioning at all, and will wreak great hardship on office workers, as well as patrons of movies and restaurants.

Air-conditioning has always been a favorite target for puritanical government officials; during the trumped-up "energy shortage" of the late 1970s, President Carter's executive order putting a floor of 78 degrees on every commercial air conditioner was enthusiastically enforced, even though the "energy saving" was negligible. As long as misery can be imposed on the consumer, why worry about the rationale? (What is now a time-honored custom in New York of reluctance to serve water to restaurant patrons originated in a long-forgotten water "shortage" of decades ago.)

There is no need for any of these totalitarian controls. If the government wants to conserve water and lessen its use, all it need do is raise the price. It doesn't have to order an end to this or that use, set priorities, or decide who should be allowed to drink more than three glasses a day. All it has to do is clear the market, and let people conserve each in his own way and at his own pace.

In the longer run, what the government should do is privatize the water supply, and let water be supplied, like oil or Pepsi-Cola, by private firms trying to make a profit and to satisfy and court consumers, and not to gain power by making them suffer.

The World Currency Crisis

Murray N. Rothbard

I: Keynesians and Fixed Exchange Rates, 1944-73

The world is in permanent monetary crisis, but once in a while, the crisis flares up acutely, and we noisily shift gears from one flawed monetary system to another. We go back and forth from fixed paper rates to fluctuating rates, to some inchoate and aborted blend of the two. Each new system, each basic change, is hailed extravagantly by economists, bankers, the financial press, politicians, and central banks, as the final and permanent solution to our persistent monetary woes.

Then, after some years, the inevitable breakdown occurs, and the Establishment trots out another bauble, another wondrous monetary nostrum for us to admire. Right now, we are on the edge of another shift.

To stop this shell game, we must first understand it. First, we must realize that there are three coherent systems of international money, of which only one is sound and non-inflationary. The sound money is the genuine gold standard; "genuine" in the sense that each currency is defined as a certain unit of weight of gold, and is redeemable at that weight.